IN THE MATTER OF THE APPLICATION REGARDING CONVERSION OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner: Docket No. G02-45

SUPPLEMENTAL REPORT OF

E. Lewis Reid

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CONFIDENTIAL and PROPRIETARY
NOT FOR PUBLIC DISCLOSURE

Background of Supplemental Report

I have been retained as a consultant[1] by PREMERA, a Washington miscellaneous nonprofit corporation ("PREMERA"), Premera Blue Cross, a Washington nonprofit corporation ("PBC"), and certain of their affiliates (collectively "Premera") to provide a reports to Premera in connection with Premera's proposal to convert from nonprofit to for-profit status, and to create two Health Foundations (the "Washington Foundation" and the "Alaska Foundation," collectively the "Health Foundations") to serve unmet health needs in Washington and Alaska (the "Conversion Transaction").

My initial report ("Initial Report") was filed November 10, 2003. This supplemental report will comment upon the Premera proposal as reflected in the amended Form A filed on February 5, 2004 and upon certain of the matters and conclusions contained in reports filed by consultants engaged by the staff of the Washington State Office of Insurance Commissioner (the "OIC Staff").

I was formerly President and CEO of The California Endowment, the largest private foundation created in a Blue Cross or Blue Shield conversion, and I continue to serve on its Board of Directors at this time. Prior to joining The California Endowment in 1998, I was an attorney in San Francisco and was counsel to Blue Cross of California in its 1996 conversion to for-profit status. My clients also included The California Endowment, the California HealthCare Foundation, the Alliance HealthCare Foundation and the Sierra Health Foundation, all foundations created in the conversion of nonprofit health organizations to for-profit status.

In addition to the materials referred to in my Initial Report filed November 10, 2003,[2] in preparing this report I have reviewed the following[3]:

- Premera's amended Form A and Exhibits filed with the OIC on February 5, 2004 ("Amended Form A");
- Supplemental Report of Cantilo & Bennett LLP dated February 27, 2004 ("C&B Supplemental Report");
- The Blackstone Group, *Update Report on Valuation and Fairness of the Proposed Conversion*, dated February 27, 2004 ("Blackstone Update");
- PricewaterhouseCoopers ("PwC"), *Report Addendum to the Report to the Washington State, Office of Insurance Commissioner on Tax Matters in*

[1] I have been retained solely as a consultant and am not acting as legal counsel for any party in this proceeding.

[2] Premera's Form A and Exhibits filed with the OIC on September 26, 2002 ("Original Form A"); Cantilo & Bennett, LLP Final Report to the OIC dated October 27, 2003 ("C&B 2003 Report"); The Blackstone Group *Report on Valuation and Fairness of the Proposed Conversion* dated October 27, 2003 ("Blackstone 2003 Report"); and PricewaterhouseCoopers ("PwC") *Report to the Washington State, Office of Insurance Commissioner on Tax Matters in Connection with the Proposed Conversion of Premera* dated October 27, 2003 ("PwC Tax Report").

[3] I have also reviewed various reports submitted to the Alaska Division of Insurance ("ADI"). I expect to address reports by ADI consultants in a report to be filed in the ADI proceedings.

Connection with the Proposed Conversion of Premera, dated February 27, 2004 ("PwC Tax Addendum"); and

- PricewaterhouseCoopers ("PwC"), *Exhibit 1: Report on Tax Matters in Connection with the Washington Foundation Shareholder and The Alaska Health Foundation*, dated February 28, 2004 ("PwC Foundation Report")

Introduction to the Supplemental Report

The Original Form A filed in this proceeding contemplated a tax-free reorganization in which New Premera would initially be the wholly owned subsidiary of a single Foundation Shareholder exempt from taxation under section 501(c)(4) of the Internal Revenue Code. As the stock held by the Foundation Shareholder was sold, it was contemplated that the proceeds would be distributed promptly to two section 501(c)(3) private foundations, one in Washington, the other in Alaska. The transaction proposed was desirable in that it would release hundreds of millions of dollars now locked up in Premera's taxable nonprofit corporate structure to address the health needs of Washington and Alaska residents, while giving Premera access to capital by becoming a public company.

The structure of the proposed transaction has been altered in the Amended Form A filed February 5, 2004. The principal issues in the original and amended Plans discussed in this Supplemental Report are these:

- Mission of the Washington Foundation;
- Structure and Tax Exempt Aspects of the Transaction;
- Governance of the Washington Foundation;
- Governance of New Premera;
- Disposition of New Premera Stock by the Health Foundations.

As amended, the Conversion Transaction remains a proposal that will serve the public interest by permitting Premera to continue as a vital company with access to the capital markets, while unlocking the charitable potential in its assets through two new large sources of philanthropic health funding in the states of Washington and Alaska.

Mission of the Washington Foundation

As a consequence of the health care conversions over the past fifteen years, there has been a burst of new health philanthropy in the United States.[4] The health foundations created in the conversion of Blue Cross/Blue Shield and other health care organizations

[4] As of 2000, more than 122 new health foundations had been created as a direct result of nonprofit to for-profit conversions. Harry Snyder, Consumers Union of the U.S., Inc. and Deborah Cowan, Community Catalyst, Inc., *Building Strong Foundations, Creating Community Responsive Philanthropy In Nonprofit Conversions* (2001), at 2.

to for-profit entities have addressed needs not easily solved either by government or by traditional health insurers. For example, I am aware from my experience as President & CEO and a board member of The California Endowment that

- Millions of our residents are uninsured;
- Only a fraction of the persons eligible for Medicaid coverage are enrolled;
- Only a fraction of the children eligible for federally funded CHIP coverage are enrolled;
- Undocumented immigrants have health care needs but are largely left outside our health care delivery system;
- The uninsured often use hospital emergency rooms as their primary care resource, driving up the operating costs for hospitals in a particularly inefficient allocation of resources;
- The safety net for the uninsured and particularly the community clinic system are under dire economic stress;
- Financial support and technical assistance to community-based organizations are needed to strengthen the safety net;
- Significant disparities in the health status of ethnic minorities exist, particularly in diseases such as diabetes and asthma;
- Community mental health systems are generally inadequate and under-funded;
- Independent forums for convening all of the interested parties in our health care systems need to be expanded;
- The demographics of our aging population will pose severe challenges to our health systems in coming decades;
- Rising costs are limiting the availability of health care in rural areas, and rural hospitals and clinics are under particular stress;
- Dental care is inadequate in many rural populations; and
- There is a need for more health care workers, especially nurses, and for the health care work force to be more diverse.

All of these, and many more, issues are being addressed by health foundations created in conversion transactions in other states.

I understand that Premera has held a series of meetings with stakeholders and community groups to hear what needs are most critical in the States of Washington and Alaska. The purpose clause of the Washington Foundation's Articles of Incorporation was drafted to reflect the advice received in those meetings. As drafted, the mission incorporates input

from community organizations and targets a wide range of health and health care issues.[5] The overall purpose of the Washington Foundation is "*to promote the health of the residents of the State of Washington . . .."* It contemplates in subparagraph (a) that the Washington Foundation will engage in *"health education and awareness,"* in (b) that the programs will address both health care and *"related services,"* and in (f) recognizes the importance of *"community based and culturally competent programs . . .."* It also gives the Washington Foundation latitude to provide *"grants"* and to establish *"programs."*

The Washington Foundation's purpose implicitly addresses the issues of behavioral and environmental determinants of health.[6] To do so is important. Our health does not depend solely upon the health care delivery system. Behavior and environment are also critical. Unhealthy behaviors, such as smoking, bad diet, alcohol and drug abuse, lack of exercise, and unsafe sex, harm our health and add huge amounts to our health care costs. Environmental factors are contributing to staggering levels of asthma in some minority populations. The mission is broad enough to address all of the needs listed above.

Cantilo & Bennett assert that, in coming to a decision, the Commissioner should not give significant weight to the "purported" benefits of the Washington Foundation.[7] They are wrong. The benefits are palpable, not purported. The California Endowment received approximately $3.0 billion in proceeds from the conversion of Blue Cross of California. That endowment has enabled it to make charitable distributions of $150 million to $200 million a year to address problems such as those listed above and, despite the recent bear market, to grow to $3.5 billion.

The Health Foundations created by the Premera Conversion Transaction may not be as large as The California Endowment. However, if the amount realized by the Health Foundations were to be in the range of $500 million to $600 million, the amount per

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[5] **Section 1**. **Purposes.** The Corporation is organized exclusively for the promotion of social welfare and charitable purposes within the meaning of Section 501(c)(4) of the Internal Revenue Code of 1986 (the "Code") subject to the limitations set forth in these Articles of Incorporation. Subject to Section 501(c)(4) of the Code and the regulations thereunder (as the same may be amended or replaced), the Corporation's specific purposes are to promote the health of the residents of the State of Washington by such measures as:

(a) improving health education and awareness;
(b) improving the quality of health care and access to health care and related services;
(c) addressing the unmet health care needs of low-income uninsured and underinsured populations;
(d) supporting the education of health care providers to increase the number of active physicians, including specialists, and nurses in medically underserved areas;
(e) supporting programs aiming to (i) make health care delivery more comprehensive and flexible, and (ii) develop and promote the most efficient uses of health care facilities, resources, and services;
(f) supporting community based and culturally competent programs that may address one or more of the foregoing purposes;
(g) conducting health policy research and analysis for the development of health policy that will promote systemic change in the programs and activities related to the foregoing purposes; and
(h) providing grants and establishing programs to carry out such purposes.

Amended Form A, Exhibit E-1, Art. III, section 1.

[6] As the Alaska Foundation's Articles do explicitly by reference to *"health and wellness"* and *"public health needs and concerns."* Amended Form A, Exhibit E-3, Art III, section 1.

[7] C&B Supplemental Report at 49.

capita available to health philanthropy in Washington and Alaska would be roughly equivalent to that available in California from The California Endowment, the largest foundation ever created in a Blue Cross/Blue Shield conversion.[8]

The $8 billion Robert Wood Johnson Foundation located in New Jersey is the largest health-related private foundation in the country. It conducts health-related charitable programs throughout the United States. By focusing their efforts solely on Washington and Alaska, the Health Foundations can potentially have a greater per capita influence on health in these two states than the Robert Wood Johnson Foundation.[9]

The potential size alone of these two proposed Health Foundations demands the Commissioner's favorable consideration. Despite Cantilo & Bennett's dismissive comments, the potential for hundreds of millions of dollars for health philanthropy cannot be ignored. That potential is an important reason for the Commissioner to proceed with the Conversion Transaction. The strength and vigor of hundreds of Washington's community-based organizations can be permanently enhanced by the infusion of such a large philanthropic endowment into the state. Given the practice of charities to pursue programs that leverage their assets for greater social impact, the Washington Foundation's influence could well be much greater than the size of its endowment. The potential benefits of the Washington Foundation to residents of Washington are so profound that they must be considered by the Commissioner.

Structure and Tax Exempt Aspects of the Conversion Transaction

The "two tier" plan originally proposed by Premera was unique among Blue Cross/Blue Shield conversion transactions. The plan had the benefit that a single nonprofit shareholder would receive and manage the monetization of the New Premera stock. In that plan the management of the monetization of the stock and the charitable tasks were unbundled. Because the Foundation Shareholder was permitted to engage in more than insubstantial lobbying, this two-tier approach minimized the risk that the Internal Revenue Service would recognize the Foundation Shareholder as a section 501(c)(3) private foundation, rather than a section 501(c)(4) social welfare organization.

At the insistence of the Washington and Alaska agencies and their consultants, Premera agreed to change this structure. The two-tier structure proposed in the original Form A has been abandoned in the Amended Form A filing in favor of a one-tier structure with a new section 501(c)(4) entity for each of the states of Washington and Alaska.[10] Premera made this change because the states of Washington and Alaska wished to have more direct control over the management and disposition of their respective conversion assets. But the control comes at a possible price. There may be an increased risk that the

[8] This statement is based upon the 2001 census, which reports that California's population is 34,501,130, Washington's population is 5,984,973 and Alaska's population is 634,892.

[9] This statement is based upon the 2001 census, which reports that the population of the United States of America is 284,796,887.

[10] C&B Supplemental Report at p. 33 notes that it is now "the apparent goal of all of the parties … that the Shares be transferred to a § 501(c)(4) organization . . .."

Internal Revenue Service will not recognize the two state Health Foundations as section 501(c)(4) entities.[11] If they were recognized as section 501(c)(3) private foundations, rather than section 501(c)(4) social welfare organizations, one of the consequences would be federal excise taxes on the sale of New Premera stock and subsequent investment income.

In the Original Form A, reflecting the two-tier foundation structure, the long term charitable activities were separated from the task of holding the initial New Premera stock and managing its divestiture and the distribution of sale proceeds. A single Foundation Shareholder was to hold and sell the stock, and promptly to distribute the sale proceeds to two section 501(c)(3) charitable organizations.

The Foundation Shareholder was to be recognized as tax exempt under section 501(c)(4) of the Internal Revenue Code. As such, it would enjoy several tax benefits not shared by a section 501(c)(3) private foundation. There would have been:

- No tax on the sale of New Premera stock (as opposed to the section 501(c)(3) private foundation's excise tax of up to 2%);[12]
- No Internal Revenue Code requirement to divest the New Premera stock (as opposed to the section 501(c)(3) private foundation's five year divestiture requirement);[13]
- No Internal Revenue Code charitable distribution requirement (as opposed to the section 501(c)(3) private foundation's annual 5% distribution requirement);[14] and
- No prohibition on certain agreements with New Premera that provide more flexibility in the sale of New Premera stock (as opposed to the section 501(c)(3) private foundation's restriction on, among other things, loans or sales to or from New Premera).[15]

The expectation that the Internal Revenue Service would recognize the Foundation Shareholder as a section 501(c)(4) entity was based in large part upon the fact that lobbying was to be a substantial part of its activities. Lobbying may not be a "substantial" part of the activities of a section 501(c)(3) entity, and is entirely prohibited for section 501(c)(3) private foundations. I concluded, as did the author or the PricewaterhouseCoopers report,[16] that the original two-tier plan was the best of the several alternatives considered.

The amended proposal adopts a one-tier, section 501(c)(4) structure. The new plan collapses the two tiers and two functions (philanthropy and stock monetization) into one

[11] PwC Foundation Report at E-12. *See* Deposition of Lundy, at p. 54, ll. 3-7.

[12] Internal Revenue Code section 4940.

[13] Internal Revenue Code section 4943.

[14] Internal Revenue Code section 4942.

[15] Internal Revenue Code section 4941.

[16] Deposition of Lundy, at p. 127, ll. 6-8.

tier. The new plan envisions that the two Health Foundations will be recognized as section 501(c)(4) entities. If so recognized, the Health Foundations will enjoy the same benefits enjoyed by the Foundation Shareholder in the original plan:

- No tax on the sale of New Premera stock;
- No Internal Revenue Code requirement to divest the New Premera;
- No Internal Revenue Code 5% distribution requirement; and
- No prohibition on certain agreements with New Premera that provide more flexibility in the sale of New Premera stock.

The last point is critical to the transaction. If the Health Foundations were section 501(c)(3) private foundations, certain provisions of the Registration Rights Agreement might not be permitted under the "private foundation rules."[17] Section 4941 of the Internal Revenue Code limits certain transactions between section 501(c)(3) private foundations and their "substantial contributors." Transactions proscribed by the section subject both parties to the transaction to excise taxes. If New Premera issued 100% of its stock to two section 501(c)(3) private foundations, or made the grants contemplated in the Transfer, Grant and Loan Agreement to section 501(c)(3) private foundations, New Premera could be a "substantial contributor" and thus treated as a "disqualified person" subject to section 4941. The kinds of transactions prohibited by section 4941 (with some exceptions) include, for example, *"sale or exchange, or leasing, of property between a private foundation and a disqualified person;"* and *"lending of money or other extension of credit between a private foundation and a disqualified person; . . ."* Were the Washington Foundation subject to the prohibitions contained in Internal Revenue Code section 4941, the application of that section could inhibit flexibility in selling it New Premera stock.[18] This is one of the reasons that section 501(c)(4) organizations have been the holders of the initial stock in some other conversion transactions, and a compelling reason to favor a section 501(c)(4), rather than a section 501(c)(3), entity as the Washington Foundation.

There is one tax advantage of the new plan over the prior two-tier plan. The new single-tier plan proposes that the continuing philanthropic activities be conducted by the Health Foundations as section 501(c)(4) entities not subject to the section 501(c)(3) private foundation excise tax on investment income. If the Washington Foundation gains recognition as a section 501(c)(4) organization, it will never pay tax on its investment income.[18] In the prior plan, the Health Foundations in each of the states were to be section 501(c)(3) private foundations. They were to receive the proceeds of the sale of the New Premera stock from the section 501(c)(4) Foundation Shareholder. Their

[17] Internal Revenue Code section 4941.

[18] As an example, various provisions of the Registration Rights Agreement might not be permissible. It is not clear that the exception for transactions involving corporate reorganizations would be applicable. Internal Revenue Code section 4941(d)(2)(F).

[19] There is an exception if the Washington Foundation has unrelated business taxable income, e.g. income from debt financed property. Internal Revenue Code sections 501(b), 511, 512.

investment income on the proceeds, as reinvested by them, would have been subject to the tax under section 4940 of the Internal Revenue Code. Over a long period of time, that could have been a substantial tax.

In its original report on the tax consequences of the transactions, PricewaterhouseCoopers considered the one-tier section 501(c)(4) model contained in the Amended Form A filing.[19] A drawback identified by PricewaterhouseCoopers for this structure was that it might be difficult to obtain recognition for the Health Foundations as 501(c)(4) entities if their articles and bylaws contain provisions that mimic the private foundation rules.[20] PricewaterhouseCoopers believes that a source of this difficulty in obtaining recognition of the Health Foundations as 501(c)(4), rather than 501(c)(3), organizations would be quasi-private foundation rules embedded in the corporate charter and bylaws.[21] With such provisions in the Articles of Incorporation, the Washington Foundation would look too much like a section 501(c)(3) private foundation.

A major purpose of the Foundation Shareholder in the original one tier plan was lobbying. This would have inhibited its recognition as a section 501(c)(3) entity. Lobbying by the Health Foundations is limited in the Amended Form A filing. Limiting or forbidding lobbying increases the risk of recognition as a section 501(c)(3) private foundation. However, the proposed Articles of Incorporation of the Washington Foundation are drafted to reduce the difficulty in obtaining the desired recognition as a section 501(c)(4) entity. Quasi-private foundation rules are not embedded in the proposed Articles of Incorporation. Nor do the Articles of Incorporation of the Washington Foundation incorporate by reference the private foundation rules, as required for a section 501(c)(3) private foundation.[22]

PricewaterhouseCoopers notes that obtaining recognition as tax exempt entities may take several months.[23] During the process, the Internal Revenue Service may insist upon changes to the transaction documents. PricewaterhouseCoopers suggests that the closing and transfer of New Premera stock to the Washington Foundation should be delayed "until it has received a definitive favorable determination."[24] That may be neither practical nor necessary.

In the Original Form A, one of the conditions to closing was that:

[19] PwC Tax, Exhibit 1, at E-10 and E-36.

[20] Internal Revenue Code sections 4940-4945.

[21] PwC Tax, Exhibit 1, at E-11.

[22] Internal Revenue Code, section 508(e)(1).

[23] PwC Foundation Report at E-30.

[24] PwC Foundation Report at E-30.

> *unless waived by PREMERA, the Foundation Shareholder shall have received a determination letter from the Internal Revenue Service that it is exempt from taxation under Section 501(c)(4) of the Code.*[25]

The Amended Form A has altered that language:

> *the Washington Foundation Shareholder shall have received (or applied for) a determination letter from the Internal Revenue Service that it is exempt from taxation under Section 501(a) of the Code.*[26]

The newer version contemplates that the recognition letter may not have been received at the time of the IPO, and that the Washington Foundation eventually may be tax-exempt under either section 501(c)(3) or section 501(c)(4). Although this may appear to be a significant change, it is not. Given that PREMERA had the right to waive the condition in the Original Form A, the outcome is the same in both the Original and Amended Form A filings: the transaction may close before the recognition letter is obtained, and recognition may come as a section 501(c)(3) entity, rather than a section 501(c)(4) entity.

The tax-exempt status of the Washington Foundation with the Internal Revenue Service does not depend upon having obtained the determination letter; it depends upon being an organization "described" in a particular subsection of section 501(c), and giving notice to the Internal Revenue Service by filing application for recognition as a tax exempt organization.[27] There is a limit on retroactive recognition of a section 501(c)(3) organization; its application for recognition must be filed with the Internal Revenue Service within fifteen months of the month of its organization in order for the recognition to apply retroactively.[28] Shortly, the Washington Foundation may be incorporated and its application for recognition filed with the Internal Revenue Service. If so, the fifteen month limitation will be inapplicable. No such restriction on retroactive recognition applies to a section 501(c)(4) entity.

Filing now will enable the parties to know the Internal Revenue Service response to the documents at an earlier time, and will increase the likelihood of certainty about the Washington Foundation's tax status at the time of the IPO. Whether recognition can be obtained prior to regulatory approval may depend upon whether the Internal Revenue Service can be informed about any conditions upon which the regulatory approval will be granted.

The Bylaws require the fiscal year of the Washington Foundation to be a calendar year.[29] A tax return may have to be filed before the tax status is known, and possibly earlier than

[25] Original Form A, Plan of Conversion section 4.3(a)(iv)(C).

[26] Amended Form A, Plan of Conversion section 4.3(a)(iv)(C). The C&B Supplemental Report objects to receipt of the recognition letter as a condition to closing in the PREMERA Restated Articles, but the condition in the Articles is not that it be received, merely that the recognition be "applied for." Amended Form A, Exhibit A-2, Article XII, sec.2.

[27] Internal Revenue Code section 501(a).

[28] Internal Revenue Code section 508(a), Treas. Reg. section 1-508-1.

[29] Section 9.2 of the proposed bylaws sets the fiscal year of the corporation as the calendar year. Amended Form A, Exhibit E-2, section 9.2.

if there were flexibility to choose a different fiscal year. Presumably, if the tax return filing date, with extensions, arrives before the recognition letter, the Washington Foundation would file as a section 501(c)(4) entity, whether or not the Conversion Transaction had closed.[30]

In summary, it would be vital to know the section under which the Washington Foundation will be recognized by the Internal Revenue Service only if recognition as a section 501(c)(3) and the consequent 2% tax on all of the sale proceeds would cause the parties to decide not to consummate the transaction.

Governance of the Washington Foundation

The Plan of Conversion in the Amended Form A promotes both long-term philanthropy and shorter term monetization of the initial New Premera shares. The current plan contemplates that:

- New Premera's right of observation of the Washington Foundation board has been eliminated;
- The first non-Premera board of directors will be appointed by the Attorney General upon regulatory approval, rather than upon closing of the Conversion Transaction;
- Compensation of directors is prohibited;
- The Articles of Incorporation and Bylaws are amendable with a ¾ vote of the directors in office, and the prior written approval of the Attorney General;
- Delivery of New Premera shares at the closing is conditioned upon the Articles of Incorporation and Bylaws not being amended during the period between regulatory approval and the IPO;
- The Washington Foundation will be required to document its gifts in grant agreements; and
- An Investment Committee and a Program Committee, with special qualifications for membership, are required by the bylaws.

Right of Observation. The original Form A filing included a right of observation of the Washington Foundation board by New Premera. This was a much milder form of oversight by the converting company than the Blue Cross and Blue Shield Association imposed on the California HealthCare Foundation, recipient of WellPoint stock in the Blue Cross of California conversion. In that conversion, a majority of the foundation board were required to be former Blue Cross of California directors, or elected by former Blue Cross of California directors until substantially all of the WellPoint stock had been divested. There were no interlocking directors. Having watched the directors of

[30] If the recognition letter is not obtained prior to the IPO, it will not be possible to know with certainty whether there is a tax on the sale of the shares. A section 501(c)(3) private foundation and a section 501(c)(4) organization file different tax returns (Form 990PF and Form 990 respectively); tax would be due on a section 501(c)(3) private foundation return and would not on that of a section 501(c)(4) return.

California HealthCare as their outside general counsel for two years after the closing, I am convinced that the California HealthCare Foundation directors acted for the benefit of California HealthCare Foundation, not WellPoint. However, the OIC and its consultants believed New Premera's observation rights would impinge upon the independence of the Washington Foundation. Those rights have been eliminated in the Amended Form A.

The independence of the Washington Foundation represented by the current proposal is a dramatic relaxation of the more stringent governance requirements imposed upon the California HealthCare Foundation. The elimination of New Premera's right of observation is not likely to harm either the Washington Foundation or New Premera.

Permanent Board Selection. The selection of both the "second" (pre-closing) and "third" (post closing) boards of directors of the Washington Foundation is vested in the Attorney General by the Amended Form A documents. If the Attorney General is to discharge that duty to select the "third" board in a responsible way, a wide-ranging search should be initiated to assure the appointment of a broadly representative, non-political, diverse board for the foundation. The California model for board selection, administered by Blue Cross of California itself, has drawn praise from consumer groups.[31] It employed an ethnically diverse consortium of search firms that identified an initial pool of over 1,000 potential candidates. The identities of the candidates were not known outside the search firms until the pool had been reduced to significantly less than 100 candidates. The Commissioner of Corporations retained a veto over any nominee, but having seen the final pool of about 25 candidates, he accepted all of the candidates. The final choices fell to those Blue Cross of California board members who were leaving that board to join the board of either of the two foundations created in the transaction.

Altering the Washington Foundation's Articles or Bylaws Before Closing. The C&B Supplemental Report notes that under the Amended and Restated Articles of Incorporation of PREMERA,[32] the New Premera stock will not be transferred to the Washington Foundation if its Articles of Incorporation or Bylaws have been amended, altered or repealed.[33] The report argues that amendments must be permitted if changes

[31] "The public prominence of the California Endowment, as well as its mission, called for a broad-based inclusive recruitment process for its board. The process included both an outreach component to identify potential candidates and a point of access for interested individuals and groups who wanted to initiate consideration of themselves or other candidates for board membership. A diverse blend of highly respected, seasoned search firms formed an executive search consortium to conduct outreach efforts throughout California. The search process sought to identify and recruit board candidates who represented the diversity of the state and the optimal skill mix from both corporate and nonprofit communities. The search consortium included a large international firm specializing in health care, a sole proprietorship focused on outreach to the Latino community, a mid-sized firm with a proven track record in diversity searches, and a 50% female-owned nonprofit search firm. The search firms assembled a Search Advisory Group of health care and business leaders to provide strategic advice and counsel regarding the search project. The new board member recruitment, screening and final selection process included comment and approval by the California Department of Corporations. Eleven of the eighteen initial California Endowment Board members were newly selected for board service through the Search Advisory Group. Harry Snyder, Consumers Union of the U.S., Inc. and Deborah Cowan, Community Catalyst, Inc., *Building Strong Health Foundations, Creating Community Responsive Philanthropy In Nonprofit Conversions* (2001), at 11.

[32] Amended Form A, exhibit A-2.

[33] C&B Supplemental Report at 33.

required by the Internal Revenue Service during the review of Washington Foundation's exemption application are to be implemented.

In the Original Form A filing, Premera would have had control over the tax exemption application, and amendment of the Articles and Bylaws, until closing. Obviously, OIC consent to an amendment would have been required because the forms of Articles and Bylaws were exhibits to the Form A. In the Amended Form A, Premera has ceded control of the Washington Foundation during the period prior to closing to a non-Premera board appointed by the Attorney General. Premera cannot also be expected to give the Attorney General and the "second" board of directors unilateral power to change the terms of the transaction after regulatory approval and prior to closing. If changes in the Washington Foundation Articles and Bylaws are required in order to obtain Internal Revenue Service recognition of the Washington Foundation as a section 501(c)(4) entity, Premera must be a party to that discussion.

Board Compensation. The currently proposed structure prohibits compensation for members of the Washington Foundation board of directors.[34] The C&B Supplemental Report is equivocal on the subject of board compensation, stating

> *there is not a strong reason to … compensate the Board of Directors. Qualified individuals with the requisite experience necessary to execute the Washington Foundation's purposes will do so because of their desire to further the public interest and not because of any compensation which they may receive.*[35]

My experience differs from that of the authors of the C&B Supplemental Report. Prohibiting board compensation is inconsistent with the predominant practice in the health conversion foundations and, I believe, may tend to screen out board members whose economic status would make it difficult to commit time to service on the board without compensation. Properly performed, board service on a large health foundation is hard work. It requires commitment and concentration. Expectations of director performance should be high. Prohibiting compensation will tend to encourage an elitist board of directors. It will also tend to reduce the time and energy directors devote to the board, shifting the locus of foundation policy from a broadly diverse board of directors to foundation staff. Compensation of the board of directors of Washington Foundation should not be prohibited.

Amendment of Articles and Bylaws. The Articles of Incorporation are amendable by a ¾ vote of the board, with the prior written approval of the Attorney General. The C&B Supplemental Report suggests that the high vote requirement for amending the articles and bylaws "reduces the flexibility" of the board of directors of the Washington Foundation.[36] The terms of the Articles and Bylaws, having been the subject of intense

[34] Washington Foundation Bylaws, section 3.11.

[35] C&B Supplemental Report at 25.

[36] C&B Supplemental Report at 30.

negotiations and regulatory proceedings in two states, should be afforded the protection of a high standard for amendment.

The California Endowment has a similar restriction that prohibits amendments of key provisions of its articles and bylaws without consent of the Attorney General. On at least two occasions, there were critical issues that required amendments. On those occasions the foundation sought, and obtained, Attorney General consent. It would be highly unusual to seek the Attorney General's approval for a request not backed by virtually unanimous support of the board of directors. The high vote requirement is appropriate, and should not be an impediment to legitimate proposed amendments to the governing documents.

There are non-amendable limitations in the transaction documents other than the Articles and Bylaws. For example, the Washington Foundation's Articles of Incorporation contain a limitation that:

> *the Corporation shall not engage in any lobbying, within the meaning of the Code, in relation to any matters that <u>may result</u> in material adverse changes in the operations of Health Insurers. "Health Insurer" shall be defined as any entity engaged in the business of providing coverage of or the administration of health benefits, including, without limitation, any health insurer, health care service contractor, hospital and medical service corporation, health maintenance organization, health carrier or health plan in Washington. (Emphasis added.)*

But in a similar, non-amendable, provision in section 1.03 of the Transfer, Grant and Loan Agreement the trigger is "likely would result, rather than "may result." Confusion might be avoided if the differing provisions were reconciled. It might also be desirable to note any restrictions that will survive the sale of the New Premera stock in a conspicuous place so that the management of the Washington Foundation will continue to be aware of the limitations on their activities over the years.

<u>Conflicts Regarding the Breadth of the Mission.</u> The mission of the Washington Foundation set forth in its proposed Articles of Incorporation is well conceived. In connection with the closing of the Conversion Transaction, the Washington Foundation will execute the Transfer, Grant and Loan Agreement. A proviso in the agreement says its assets may be used "solely" to make "grants" to section "501(c)(3)" entities.[37] This restriction limits the broader purposes in the Articles of Incorporation. Health foundations customarily do not use their assets "solely" to make "grants." Nor do they make grants "solely" to section "501(c)(3)" entities. Broadening the language in the Transfer, Grant and Loan Agreement to match the Articles of Incorporation would enable the Washington Foundation to conduct routine foundation affairs, and to realize the vision of the mission stated in its Articles of Incorporation.

[37] Transfer, Grant and Loan Agreement, section 1.02.

Most foundation funds are expended for grants to section 501(c)(3) organizations. However, funds are usually also expended for personnel and administrative costs, asset management fees, internal and external communications, program evaluation, program development research, health policy research, technical assistance to community based organizations and sundry other expenditures that are not "grants." For example, program related loans, a very powerful philanthropic tool, are beneficial both to the foundation lender and the nonprofit borrower. In my view, expenditures and programs other than "grants" should be permitted as contemplated by the proposed Articles of Incorporation.

When foundations make grants, the grants are usually made to organizations exempt from taxation under section 501(c)(3). But grants to other organizations are also desirable. At The California Endowment, we have made many grants to organizations other than section 501(c)(3) entities. These have included grantees exempt from taxation under section 501(c)(4), section 501(c)(5), and section 501(c)(6) of the Internal Revenue Code.[38] Grantees have also included public agencies and organizations not yet recognized as exempt.[39] It would be desirable to permit the Washington Foundation to make grants both to section 501(c)(3) organizations and to other tax exempt organizations as the Articles also contemplate.

Requirement of Grant Agreements. The C&B Supplemental Report objects to the provision in section 3.02 of the Transfer, Grant and Loan Agreement requiring the Washington Foundation to have grant agreements with grant recipients. Other than the reference to equitable relief, the requirements of section 3.02 are procedures that a grant making foundation would routinely follow, whether or not required to do so by the agreement. The equitable relief is included to provide a right to assure that organizations with which Premera has no contractual relationship will use the funds for the specified charitable purposes and no others.

Investment Committee Qualifications. The Bylaws of Washington Foundation require it to have an Investment Committee.[40] In its conclusion, the C&B Supplemental Report misstates the qualifications for membership on the Investment Committee, stating that potential members might not have "experience with a public company as currently required."[41] Such experience is not required. The standard is *"those directors who have*

[38] For example, California Endowment grants have been made to organizations exempt under section 501(c)(4): California State Conference of the NAACP for educational activities to improve the health and well being of African Americans in California; section 501(c)(5): California Teachers Association to implement teacher-to-parent outreach programs to increase awareness on the availability of free/low cost health coverage programs among parents and families of uninsured children; and section 501(c)(6): National Hispanic Medical Association for advocacy, policy analysis and coalition building to improve the health and well being of Latinos.

[39] For example, California Endowment grants have been made to the National Centers for Disease Control and Prevention to fund additional California grantees in a CDC initiative on racial disparities in health; to the California Department of Health to expand the state funded California Health Information Survey to obtain additional data on health indicators for specific minority populations, and dissemination of survey results in minority communities; and to county public health departments to obtain their participation in new collaborative programs with community based nonprofits.

[40] Amended Form A, Exhibit E-2, section 8.5.

[41] C&B Supplemental Report at 85.

substantial business or financial management experience, such as experience as a board member or executive officer of a public company or other comparable experience."[42] This standard is quite broad and is a good guide for identifying potential candidates for Investment Committee membership.

Effect of Grants and Loans on Independence of the Washington Foundation. The C&B Supplemental Report says that to the extent funds advanced to the Washington Foundation under the Transfer, Grant and Loan Agreement are to be used for lobbying, the "independence" of the Washington Foundation may be compromised.[43] The scope of lobbying is restricted under that agreement and under the Washington Foundation's Articles of Incorporation. It is entirely proper for Premera to carve out activities potentially harmful to it, and to prohibit the charitable recipient of New Premera stock from engaging in those activities. Within the permissible scope of its charitable activities, this does not affect the Washington Foundation's independence at all.

The total grants and loans that could be made to the Washington Foundation under the Transfer, Grant and Loan Agreement amount to $500,000, based upon budgets submitted to New Premera. These grants and loans are to be made over more than one year. The Articles of Incorporation of the Washington Foundation incorporate the Internal Revenue Code section 501(c)(3) restriction on lobbying ("no substantial part of the activities"). If the Washington Foundation were a section 501(c)(3) public charity, the maximum amount of this $500,000 that could be used for lobbying under the safe harbor rule is $100,000.[44] Cantilo & Bennett worry that the Washington Foundation's independence will be lost because it can't spend $100,000 over a period of years to lobby against New Premera without submitting a budget to New Premera. In the context of a transaction that will create hundreds of millions of dollars for health philanthropy for the State of Washington, this is a specious concern.[45]

The Background of Blue Cross and Blue Shield Association License Conditions

The first conversion of a Blue Cross/Blue Shield entity occurred in 1996, two years after the licensing entity, the Blue Cross and Blue Shield Association ("BCBSA"), amended its rules to permit stock companies to hold Blue Cross/Blue Shield licenses. The principal force behind the trend over the past decade for Blue Cross/Blue Shield plans to convert to for-profit status was an action taken by Congress in 1986.

Prior to 1986, all Blue Cross/Blue Shield organizations were federally tax-exempt as either 501(c)(3) or 501(c)(4) entities. Section 501(m) was inserted in the 1986 Tax Act for the purpose of depriving Blue Cross/Blue Shield organizations of their federal tax

[42] Amended Form A, Exhibit E-2, section 8.5.

[43] Cover letter to C&B Supplemental Report at 19. C&B Supplemental Report at 26, 89.

[44] Internal Revenue Code, sections 501(h), 4911(c).

[45] Elsewhere Cantilo & Bennett acknowledge the independence of the Washington Foundation under the Amended Form A. C&B Supplemental Report at 61.

exemptions.[46] That section provides that "An organization described in . . . [section 501(c)(3) or 501(c)(4) of the Internal Revenue Code] . . . shall be exempt from tax . . . only if no substantial part of its activities consists of providing commercial-type insurance."

From 1987 forward, the Blue Cross/Blue Shield organizations were required to pay federal corporate income tax, with some softening of the blow through the benefit of section 833 of the Internal Revenue Code.[47] During the 1980s, tax-exempt hospitals and HMOs were being converted in growing numbers. They and the traditional for-profit health insurers had access to the capital markets to build their businesses. The Blue Cross/Blue Shield plans could not compete on a level playing field with their non-Blue competitors because BCBSA did not permit its licensees to organize as for-profit corporations. Thus, the Blue Cross/Blue Shield plans had the worst of both worlds: they had to pay tax on one hand, but they had no access to capital markets on the other.

When BCBSA changed its rules in 1994 to permit licensees to be for-profit companies, it was not "lured" by the ability to "cash in" on the franchise as suggested pejoratively by the C&B Supplemental Report.[48] It changed the rules to provide a more level competitive playing field where its members would have the same access to capital as their non-Blue competitors. Billions of dollars in assets previously locked up in nonprofit corporations have been released to philanthropy to serve the unmet health needs of America as a consequence of permitting Blue Cross/Blue Shield plans to become publicly held for-profit companies.

The Conversion Transaction includes a series of agreements between and among PREMERA, the Health Foundations, a voting trustee, the BCBSA, and an unallocated shares escrow agent. These include the Transfer, Grant and Loan Agreement, the Voting Trust and Divestiture Agreement, the Registration Rights Agreement, the Excess Share Escrow Agent Agreement, the Unallocated Shares Escrow Agent Agreement and the BCBSA License Addendum. Many of the restrictions contained in these agreements are derived from BCBSA conditions for permitting BCBSA licenses to be held by for-profit corporations. Those restrictions have appeared in one form or another in other Blue

[46] "Reasons for Change. The committee is concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is so inherently commercial that tax-exempt status is inappropriate." . . . "[T]he availability of tax-exempt status under present law has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in Sections 501(c)(3) or 501(c)(4). This group of organizations is now among the largest health care insurers in the United States." H.R. Rep. No. 426, 99th Cong., 1st Sess., at 664 (1985).

[47] "In the case of activities of Blue Cross and Blue Shield and their affiliates with respect to high risk individuals and small groups, the bill authorizes the Treasury Department to issue regulations providing for special treatment to such organizations. Congress intends that this special benefit be provided in connection with the unique activities (such as open enrollment) of Blue Cross and Blue Shield and their affiliates for high risk individuals and small groups, so that such activities (to the extent not engaged in by commercial insurers) are not overburdened by tax costs and therefore reduced." H.R. Rep. No. 426, 99th Cong., 1st Sess., at 665 (1985).

[48] C&B Supplemental Report at 3.

Cross/Blue Shield conversion transactions. Similar, but in some cases more limiting, restrictions were contained in the Blue Cross of California transaction and did not materially impede either the operations of the foundations created in the transaction or the success in creating wealth for the foundations by selling the WellPoint shares.

The BCBSA was reluctant to permit for-profit corporations to be licensees, because it wanted to maintain the nature and quality of the Blue Cross/Blue Shield plans and to avoid their takeover by large for-profit insurance companies, or others, that might have a very different business model. Typically, restrictions have included limitations on voting rights; control over the selection of the majority of the board of the recipient of the stock of the converted entity; limitations on the amount of shares that may be owned by "institutional" investors and "non-institutional" investors; and requirements that the stock received in the conversion be divested over time so that the company can become a widely held public company. These restrictions fall generally into the categories of provisions affecting governance of the converting licensee and provisions affecting the divestiture of the foundation's shares in the converted licensee.

Cantilo & Bennett assert that the restrictions contained in various agreements may prevent the proposed Health Foundations from receiving PREMERA's "fair market value."[49] They believe that the enterprise, though it is a BCBSA licensee, has a value independent of the license terms, and that the license restrictions take a part of that value away from the "public." They are wrong. As Blackstone acknowledges, the value of the business would shrink if the BCBS license were to be lost.[50] The BCBSA license restrictions are inherent in the business, inherent in operating as a licensee and linked to the commercial benefit of the right to use the name and mark.

Governance of Premera

BCBSA Restrictions Generally. Various governance restrictions on New Premera and the Washington Foundation are included in the transaction documents in the Amended Form A. These limitations are included, in part, to conform to BCBSA licensing conditions. Beyond that narrow purpose, they are intended to encourage continuity in management and business, maintain local control, and to discourage undue influence from a major shareholder whose agenda might be very different from that of the BCBSA or its members. Restrictions such as these preserve the independence of the boards of directors of BCBSA licensees from large controlling shareholders, including the foundations created in Blue Cross conversions. They are not arbitrary. They represent the best judgment of the BCBSA about how to protect the business of its licensees, the value of its name and mark, and the welfare of subscribers during a period of transition in the structure of ownership. In the California conversion, these restrictions facilitated a smooth transition from taxable nonprofit to a successful widely held for-profit company.

[49] C&B 2003 Report, at 23.

[50] Blackstone Update at 16.

Foundation Representation on the New Premera Board. Foundation representation on the board of directors of New Premera should not be a critical issue for the Commissioner. My direct experience involves a range of conversion transactions from the Blue Cross of California transaction, where there was no foundation representation on the WellPoint board, to a non-Blue conversion in which the boards of the company and the foundation were largely overlapping. In my opinion, a board structure with interlocking directors is not wise. It creates conflicting fiduciary duties. It also creates difficult conflicts arising out of material non-public information that the company's directors will obtain but cannot share.

In the California transaction, a majority of the California HealthCare Foundation initial board was required to be drawn from former Blue Cross of California directors. That assured that the California HealthCare Foundation board had knowledge of and experience with the company in which it was the largest shareholder. The Washington Foundation will be different. At the request of representatives of the state of Washington, the proposed Washington Foundation, as reflected in the Amended Form A, is, in the words of Cantilo & Bennett, "completely independent from New PREMERA."[51] The independence from Premera's control, vigorously sought and now obtained for the Washington Foundation, virtually assures that its board will have little background or experience in the business and affairs of Premera.

Even when some board participation by foundations has been permitted in Blue Cross/Blue Shield conversions, it has been nominal. The foundations have not been permitted to control the converted companies. The structure outlined in the Amended Form A, with a Designated Member chosen from among candidates advanced by the Health Foundations, but barred from being a director of the Health Foundations, seems likely to advance the purpose of recognizing the Washington Foundation's point of view, while avoiding the problem of conflicting fiduciary duties. The quarterly meeting of the Designated Member with the board of the Washington Foundation may be useful. Other communications between the company and the Foundation may be more important, and may provide more information to the Foundation management. These communications will be inevitable given the necessity for the Washington Foundation to divest itself of shares of the New Premera stock.

The C&B Supplemental Report argues it is important for the Washington Foundation to nominate a second separate Designated Member to the New Premera board of directors.[52] In practical effect, putting the Washington Foundation's own Designated Member on the New Premera board, rather than the single Designated Member, would not be a useful exercise. It would not further the larger objective of maximizing the funds available for health philanthropy in Washington. Once elected, either the Designated Member or a Washington Foundation nominated director will have a fiduciary duty solely to New Premera, not to an individual shareholder. The Health Foundations are not typical

[51] C&B Supplemental Report at 60.

[52] Cover letter to C&B Supplemental Report at 21.

investor-shareholders. They are nonprofits that receive the stock with a divestiture mandate. They are subject to explicit rules that prevent them from exercising control over the corporation. Without any representation on the WellPoint board of directors, the California HealthCare Foundation successfully liquidated its WellPoint holdings in less than five years. No critical interest of the Health Foundations not already addressed by the provisions for the proposed Designated Member would be advanced by separate New Premera board representation for each.

The BCBSA is unlikely to consent to a proliferation of foundation representatives on the New Premera board merely because it may have consented to a proliferation of foundations. Nor is it realistic to ask the New Premera board to be bound to accept the candidates put forward by the Health Foundations whatever their backgrounds may be. The directors of New Premera will have a fiduciary duty in the nomination of directors that should not be totally delegated to the Health Foundations. The right to reject candidates put forward by the Health Foundations for nomination as the Designated Member of the New Premera board is reasonable.

Termination of the Voting Trust and Divestiture Agreements. The consultants to the OIC urge that the Voting Trust and Divestiture Agreements should terminate immediately if New Premera's BCBSA license were to be terminated. The restrictions in the Voting Trust and Divestiture Agreements are included in part to satisfy the requirements to obtain a BCBSA waiver from its licensee ownership limits. They are not arbitrary; they serve legitimate business purposes aside from the fact that BCBSA insists upon them. They help to maintain continuity of management and operations, and protect the interests of subscribers, while New Premera is making the transition from its former nonprofit status to its ultimate object of being a widely held public company. The need for continuing an orderly divestiture of shares would not cease merely because the BCBSA license was lost. Stability should be maintained, and the business protected, in such a transitional period. The Health Foundations, focused on philanthropy, would not be in the best position to run an insurance company. The best interests of the company and its shareholders would not be served by abruptly introducing the additional uncertainty of terminating the Voting Trust and Divestiture Agreement provisions at a time of great business stress.

Disposition of New Premera Stock by the Health Foundations

The Divestiture Requirements. The Original Form A Plan of Conversion and the Amended Form A Plan of Conversion both contain milestone dates by which portions of the New Premera stock distributed at the closing must be divested. The Voting Trust and Divestiture Agreement also directs each of the Health Foundations, "to the extent consistent with its duties and obligations and purposes and taking into account market conditions, [to] reduce its Beneficial Ownership of Capital Stock in a prudent and reasonably prompt manner."[53]

[53] Amended Form A, Exhibit G-4, section 7.01.

The principal differences in the divestiture requirements in the Amended Form A and in the Original Form A are these:

- There are now two Health Foundations, treated in the aggregate for the purposes of the timetable;
- The Health Foundations' stock must be reduced to 20% within five years; and
- The time for reduction in the stock holdings of the Health Foundations to 5% has been extended from six years to ten years;
- There are more opportunities for demand and piggyback registrations; and
- blackout and holdback periods have been shortened.

The divestiture provisions require the Health Foundations jointly to sell their combined PREMERA stock by reducing their holdings to less than 80% in one year, 50% in three years, 20% in five years, and 5% in ten years.[54] Some extensions are permitted. Even without a schedule, there would be reasons for the timely sale of stock. The Washington Foundation will not be able to diversify its holdings, or to commence grant making in the community, until it sells stock. Until a significant amount of stock is in the hands of public shareholders, the market in New PREMERA shares may be depressed by the Health Foundations' ownership of such a large portion of the shares. The directors of the Health Foundations and their financial advisors will need to balance factors such as market overhang; the need to fund their charitable activities, diversify investments, and fund operations; divestiture requirements; and the current condition of the market in deciding when and how much New Premera stock to sell.

Vesting Stock in Two Health Foundations: Aggregating Their New Premera Shares. Vesting New Premera shares in two Health Foundations, rather than a single Foundation Shareholder, increases the complexity of managing the divestiture. It is also likely to increase the burden on New Premera and uncertainty in the market for New Premera shares. However, the scheme laid out in the revised Registration Rights Agreement appears to be workable if the Washington Foundation and the Alaska Foundation exercise a reasonable degree of cooperation. The increase in the number of registration demands permitted, and the shortening of holdback, blackout and other barred periods, should facilitate the selling process.

The milestones for the divestiture, with extensions possible, seem achievable. The BCBSA divestiture timetable is an integral part of the conditions on which licensees are permitted to leave their traditional nonprofit status. The objective is to move in an orderly way toward being a widely traded public company with no large controlling shareholder. The BCBSA views the divestiture as necessary to protect the value of its name and mark, the businesses of its licensees and the welfare of its subscribers.

[54] Amended Form A, Exhibit G-4, section 7.01-.04.

Now that each state will have a separate Health Foundation, the consultants to the OIC urge that their shares should not be aggregated for the purposes of meeting the divestiture schedule. If each of the Health Foundations is permitted to comply separately with the BCBSA divestiture schedule, they would be permitted to defer any sales for a number of years. However, without selling stock they will have no funds with which to conduct their charitable activities. For that reason, they are likely to sell their stock before the separate divestiture schedules would require.

If the Health Foundations do defer sales under a disaggregated schedule it could have a negative effect upon the creation of a healthy public market in the stock of New Premera. By disaggregating the divestiture requirements, the float in New Premera stock in early years could be much smaller than under a consolidated divestiture requirement. This would frustrate the objective of creating a widely held public company. It would frustrate the Health Foundations' objective of creating an endowment for charitable activities. It would frustrate the Health Foundations' objective to maximize their endowments (by depressing the stock price in a market where the public float in the stock is small and the overhang of their remaining stock is large).

The C&B Supplemental Report cites the WellChoice transaction as a precedent for disaggregation of the holdings of two entities receiving stock.[55] That transaction is not a compelling precedent. The small foundation created in that transaction had only 5% of the stock of the converted entity from the outset. It never exceeded the BCBSA 5% ownership limit. Because of the tiny initial holdings of the foundation, permitting the small foundation to own its 5% of the shares outside the voting trust had a trivial effect on the timetable for divestiture. The allocation of shares between Washington and Alaska has not yet been determined. The allocation influences the time within which shares would have to be sold under separate divestiture schedules. Under separate divestiture requirements, as the size of the smaller holding increases (and the larger decreases), the potential for both Health Foundations to defer selling their stock grows, and the risk of not achieving a healthy, orderly public market increases.

In California, as the years after the 1996 conversion of nonprofit Blue Cross of California into for-profit WellPoint unfolded, the disposition of the WellPoint stock held by the California HealthCare Foundation occurred smoothly. Within five years after the conversion, this much larger divestiture was completed. I have little doubt that under the current Amended Form A structure, if the directors of the Health Foundations are prudent in their diversification of their assets, they will have divested the New Premera stock long before the end of the ten year period. Under a disaggregated schedule there is greater risk, but if the Health Foundations respond appropriately to their needs to diversify assets and to generate funds for their charitable activities, the relaxed divestiture requirement may not have the adverse effect that it otherwise potentially could have.

[55] PriceWaterhouseCoopers have described the transaction. PwC Foundation Report at E-37.

Registration Rights. As with the other documents, the Registration Rights Agreement is now somewhat more complex because two entities, rather than one, are given demand and piggy-back registration rights. Not only has Premera agreed to the request from the states that each have its own entity to hold and monetize its shares, but other terms of the Registration Rights Agreement have also been modified significantly. There are now more demand registrations available, and the time within which demands may be made has been extended. Blackout periods and holdback periods have been shortened. Given that the original agreement was adequate for the timely monetization of the New Premera shares held by Washington Foundation, the current version should be acceptable.

Receipt of "Fair Market Value." In their earlier report, Cantilo & Bennett asserted that the restrictions contained in various agreements among and between PREMERA, the Foundation Shareholder and the Charitable Organizations "may prevent the Foundation Shareholder, or the proposed Charitable Organizations, from receiving Premera's fair market value."[56] The basis for asserting that a transfer of "fair market value" is required is dubious. The only authority cited for that principle is a reference to a statutory provision specifically limited to nonprofit hospital conversions.[57] No other substantive basis for this claim is found in their reports. Their approach to claiming that "fair market value" is not transferred is that the enterprise, though a BCBSA licensee, has a value independent of the license terms, and that the license restrictions take a part of that value away from the "public." The assertion that the license restrictions reduce the value of the business is inconsistent with concerns about how much the value of the business would decline if the BCBSA license were lost. According to Blackstone, "Once Premera is public, the loss of the BCBSA mark may significantly impair Premera's valuation in the market place."[58]

The discussion of fair market value is a distraction. Premera has no obligation to convert to for–profit status, and it acknowledges no obligation to commit its assets to charity. Nevertheless, Premera proposes to transfer 100% of the initial stock of New Premera to the Health Foundations on the day the Conversion Transaction closes. At that time the Health Foundations will own the business. The BCBSA license restrictions are inherent in the business, inherent in operating as a licensee and linked to the commercial benefit of the right to use the name and mark. Even if there were a charitable trust imposed on its assets (and there is not), Premera would not have an obligation to transfer any more than the entire enterprise to charity.

Blackstone indicates that the OIC and its legal counsel have advised that "an IPO conducted in a reasonable and customary manner could deliver fair market value to the Washington Foundation."[59] In part, this conclusion is reached because of provisions in

[56] C&B 2003 Report, at 23.

[57] C&B Supplemental Report, at 60 n.162.

[58] Blackstone Update at 16.

[59] Blackstone Update at 15.

the Amended Form A that a Pricing Committee of the Board of New Premera will make the final pricing determination after consultation with, and input from, Blackstone and other IPO Advisors. The Designated Member, chosen from candidates suggested by the Health Foundations, must sit on the Pricing Committee for several years after closing. In addition, the attorneys for the states of Alaska and Washington will be given access to documents in order to review and comment on the information that will be submitted to the SEC, investors or others as part of the Initial Public Offering.

In their original report, Cantilo & Bennett suggested that Premera should pay "its fair market value to the Foundation Shareholder in cash on the effective date of the Transaction." (Emphasis added.)[60] They did not discuss the tax, licensing, or other obstacles to this proposal. They did not acknowledge that there is no tax-free way to provide an immediate transfer of all-cash, rather than stock, to the Foundation Shareholder in a tax-free reorganization of a Blue Cross licensee. The cash in an all cash transaction would be net of tax at a rate as high as 35%.

Cantilo & Bennett have revised their "cash" argument.[61] They now suggest, again without any authority, that Blackstone must speculate about the future of the stock market, the economy and the sell or hold decisions of the Washington Foundation Finance Committee, and give the Commissioner an opinion whether the amount of future stock proceeds over the years, discounted to present value, is "reasonably likely to approximate" the current "fair market value" of New Premera. Fairness of this transaction is not dependent upon the fortunes of the economy in years to come. The speculation suggested by the C&B Supplemental Report is neither helpful nor necessary.

Conclusions

Conversion to a for-profit stock company is a legitimate way for Premera to escape the double bind of being fully taxable, but having no access to investment capital. Other Blue Cross and Blue Shield organizations around the United States have preceded Premera on this road. One of the consequences has been the creation of a new and vigorous group of health philanthropies in America. In state after state they are addressing health needs of citizens that have been ignored, or are not susceptible of being solved by government and the existing health delivery system.[62]

The mission of the Washington Foundation set out in its proposed Articles of Incorporation will enable it to address needs of the citizens of Washington in a broad range of health related areas. The Washington Foundation should be permitted to pursue that broad mission.

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[60] C&B 2003 Report, Executive Summary at 12; C&B 2003 Report at 103, 115.

[61] C&B Supplemental Report at 60-61.

[62] The notable, and shameful, exception is New York, where a political deal resulted in 95% of the conversion proceeds being committed to three-year salary increases for one union's members. See PwC Foundation Report at E-37.

The single-tier structure proposed in the Amended Form A introduces some additional complexity in the relations between interests in the states of Washington and Alaska. It also introduces some additional uncertainty in the ability to be recognized as a section 501(c)(4) entity. That said, the single tier is a perfectly feasible structure, with the additional benefit that, if realized, it will permit the Washington Foundation to be free of excise tax on its investment income in future years.

The independence of the Washington Foundation from New Premera in the Amended Form A proposal should alleviate prior expressed concerns about New Premera control. Compensation of board members should not be prohibited. Otherwise the proposed provisions for governance of the Washington Foundation should be acceptable.

The terms of the agreements that control the governance of New Premera, and the divestiture of New Premera shares by the Health Foundations, are reasonable and fair. The BCBSA restrictions, although they limit the rights of shareholders in material respects, are ultimately in the interest of all parties – New Premera, shareholders, the Health Foundations, and subscribers. Provided the leadership of the Health Foundations and New Premera work together in good faith, there should be no obstacles to an orderly monetization of their New Premera shares and diversification of the investment of their endowments.

This Report does not speak to the advantages or disadvantages of the Conversion Transaction for the continuing business of New Premera. It does, however, address the benefits that may be realized by taking the opportunity to create the Washington Foundation to answer the health needs of current and future generations of Washingtonians. The Amended Form A filing presents the Commissioner with the opportunity to capture a massive benefit for residents of the state of Washington in perpetuity. In my judgment, it would be tragic to forgo such an opportunity.